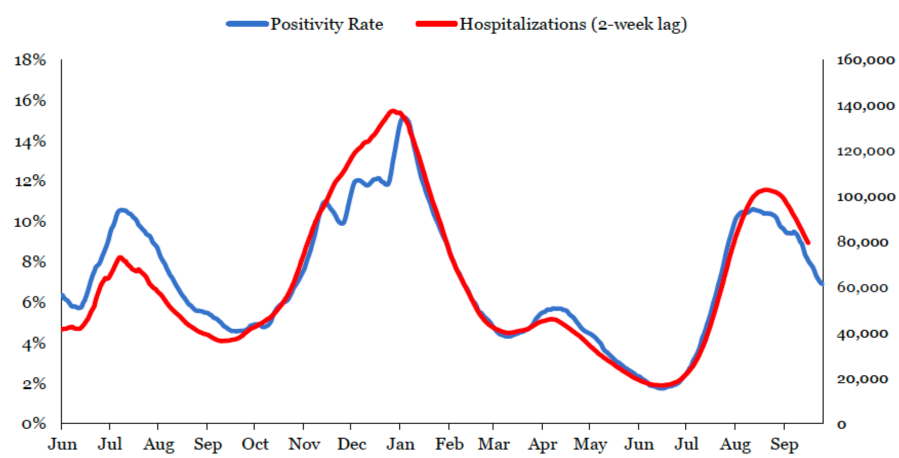
SCHAFER | CULLEN
CAPITAL MANAGEMENT

**High Dividend Value**
Q3 2021 Commentary

## Market Review:

US equities experienced a volatile 3rd quarter but finished roughly flat, as the S&P 500 was up +0.6% while the Russell 1000 Value declined -0.8%. Stocks rallied for much of the quarter, with the S&P 500 posting seven consecutive months of gains through August. However, this was followed by a sharp pullback in September on concerns regarding the Delta variant of Covid-19, continued supply chain disruptions and the impact on global growth, and shifting Fed policy, among other uncertainties. At the beginning of the quarter, the US economy appeared to be on track for a strong reopening in the fall. Although the Delta variant quickly altered that reality, new cases and hospitalizations began to roll over in August, which bodes well for a recovery and reopening as we enter 2022 (Figure 1).

**Figure 1: US Covid Trends**




Source: Strategas, Quarterly Review in Charts, 10/4/2021.

Financials was the best performing sector, up 2.7%. Several banks and insurers posted strong quarterly earnings and a late quarter jump in interest rates and rotation into Value stocks benefitted the sector. Utilities (+1.7%) was the 2nd best performing sector, rebounding slightly after being the worst-performing sector in the first half of the year. Communication Services was the next best performing sector, driven by gains in Media and Entertainment stocks while Telecom lagged. Industrials (-4.3%) was the worst-performing sector, as transportation stocks were hit particularly hard by the Delta variant's impact on travel as well as rising labor costs. Materials (-3.5%) also lagged, as commodities producers were heavily impacted by the drop in commodities prices largely due to concerns surrounding China's economy.

On the policy front, Fed Chair Jerome Powell indicated the central bank may begin tapering its monthly bond buying program by year end. Powell also said the economy has much ground to cover before reaching maximum employment, so despite elevated levels of inflation, interest rate increases are not imminent. On Capitol Hill, the Senate passed a roughly $1 trillion infrastructure package and a separate $3.5 trillion budget proposal. Both policy measures, if passed, will further lift inflation expectations and potentially drive interest rates higher.

## Performance Analysis:

The High Dividend Value Equity strategy composite returned +0.2% (gross of fees) and +0.1% (net of fees) for the third quarter of 2021 versus -0.8% for the Russell 1000 Value and +0.6% for the S&P 500. Year-to-date through Q3, the strategy returned +18.3% (gross of fees) and +17.9% (net of fees), outperforming the Russell 1000 Value and S&P 500, which returned +16.1% and +15.9%, respectively.

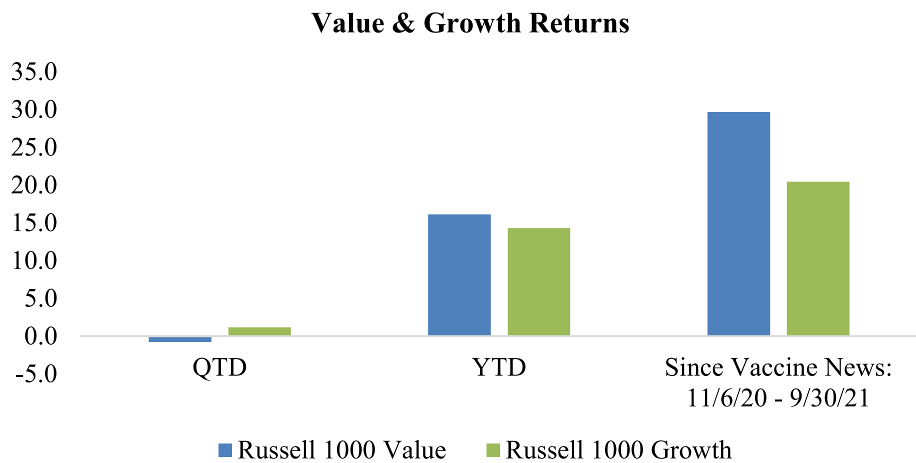
**Figure 2: High Dividend Value Equity Returns vs. Benchmark**

| September 30, 2021 | QTD | YTD | 1 Yr | 3 Yr | 5 Yr | 10 Yr | Since Incept* |
|---|---|---|---|---|---|---|---|
| High Dividend Value Equity (gross) | 0.2 | 18.3 | 33.4 | 9.1 | 10.4 | 12.1 | 10.4 |
| High Dividend Value Equity (net) | 0.1 | 17.9 | 32.9 | 8.6 | 9.9 | 11.6 | 9.8 |
| Russell 1000 Value Index | -0.8 | 16.1 | 35.0 | 10.1 | 10.9 | 13.5 | 9.6 |
| S&P 500 Index | 0.6 | 15.9 | 30.0 | 16.0 | 16.9 | 16.6 | 10.5 |

**12/31/1993. Performance for periods greater than 1 year is annualized.* ***Past performance is no guarantee of future results***

The strong US equity market returns this year have been broad-based with most style and capitalization indices participating in the rally. Value has outperformed Growth in 2021 and is ahead by more than 9% since Pfizer's successful Covid-19 vaccine trial announcement last Fall (11/6/20) (Figure 3). However, Growth stocks began to regain leadership in the second quarter. This extended into the third quarter, with the Russell 1000 Growth up +1.2%, slightly outperforming the Russell 1000 Value, which declined -0.8%.

**Figure 3: Equity Style Indices Performance (YTD)**




Source: SCCM Research, Bloomberg, 9/30/2021.

Performance by valuation quintile in the S&P 500 mirrored the spread with the highest Price/Earnings quintile outperforming the lowest Price/Earnings quintile by 140 basis points (Figure 4).

## Figure 4: Performance by Valuation Quintile

| S&P Relative Forward P/E Quintiles | | Q3 | YTD | Weight in S&P 500 | Forward P/E Ratio | Dividend Yield |
|---|---|---|---|---|---|---|
| High P/E | 11.94 To 1.54 | 0.2 | 7.4 | 23.4 | 47 | 0.4 |
| | 1.54 To 1.08 | 2.7 | 22.3 | 32.9 | 26 | 0.9 |
| | 1.08 To 0.81 | -2.8 | 11.2 | 15.9 | 19 | 1.5 |
| | 0.81 To 0.60 | -1.8 | 15.9 | 16.6 | 14 | 2.5 |
| Low P/E | 0.60 To -5.30 | -1.2 | 17.8 | 11.1 | 10 | 3.3 |

Source: BofA Research, US Performance Monitor, 10/4/2021. Forward P/E and Yield as of 9/30/21.
**Past performance is no guarantee of future results.**

Risk factors, particularly Beta, have been some of the strongest factor groups in the year. The highest beta quintile in the S&P 500 has outperformed the lowest beta quintile by 19.7 percentage points in 2021. Partially reflecting this factor trend, the highest dividend yielding quintile (dividend yield > 2.9%) – exhibiting the lowest overall beta – slightly underperformed the market in the quarter and for the year (Figure 5).

## Figure 5: Performance by Dividend Quintile

| S&P Dividend Yield Quintiles | | Q3 | YTD | Weight in S&P 500 | Forward P/E Ratio | Dividend Yield |
|---|---|---|---|---|---|---|
| Low Yield | 0.00 To 0.00 | 1.0 | 16.3 | 27.6 | 30 | 0.0 |
| | 0.00 To 0.99 | 2.1 | 15.2 | 24.6 | 27 | 0.6 |
| | 0.99 To 1.86 | -1.2 | 15.5 | 15.1 | 18 | 1.5 |
| | 1.86 To 2.93 | -0.9 | 12.9 | 19.0 | 16 | 2.3 |
| High Yield | 2.93 To 9.55 | -1.7 | 14.3 | 13.7 | 13 | 4.4 |

Source: BofA Research, US Performance Monitor, 10/4/2021. Forward P/E and Yield as of 9/30/21.
**Past performance is no guarantee of future results.**

Underneath the seemingly benign performance gap between Value and Growth has been sharp swings in relative performance between the styles, reflecting the hesitancy the market has in embracing one style over the other. The narrative supporting Value stocks centers on the stronger rebound in earnings over that of Growth stocks – the growth rate of earnings of Value stocks over Growth stocks is currently 65% higher than average. In addition, Value stocks remain ~20% under-owned in active funds and trading at significantly cheaper valuations relative to historical levels, creating a meaningful opportunity for Value stock outperformance as mean-reversion narrows these disparities. The strength in Growth stocks has been fueled by the continuation of Central Banks' quantitative easing programs, with the Fed, ECB and BOJ balance sheets expanding by 60%+ in the last 18 months. The flood of liquidity has lifted valuation multiples disproportionally benefitting growth and momentum stocks. Alongside this driver, the rise of the Delta Covid-19 variant and fears of slowing economic growth pushed interest rates lower, driving flows into long-duration growth stocks.

The overall valuation and dividend yield of the High Dividend strategy are attractive on an absolute and relative basis. At quarter-end:

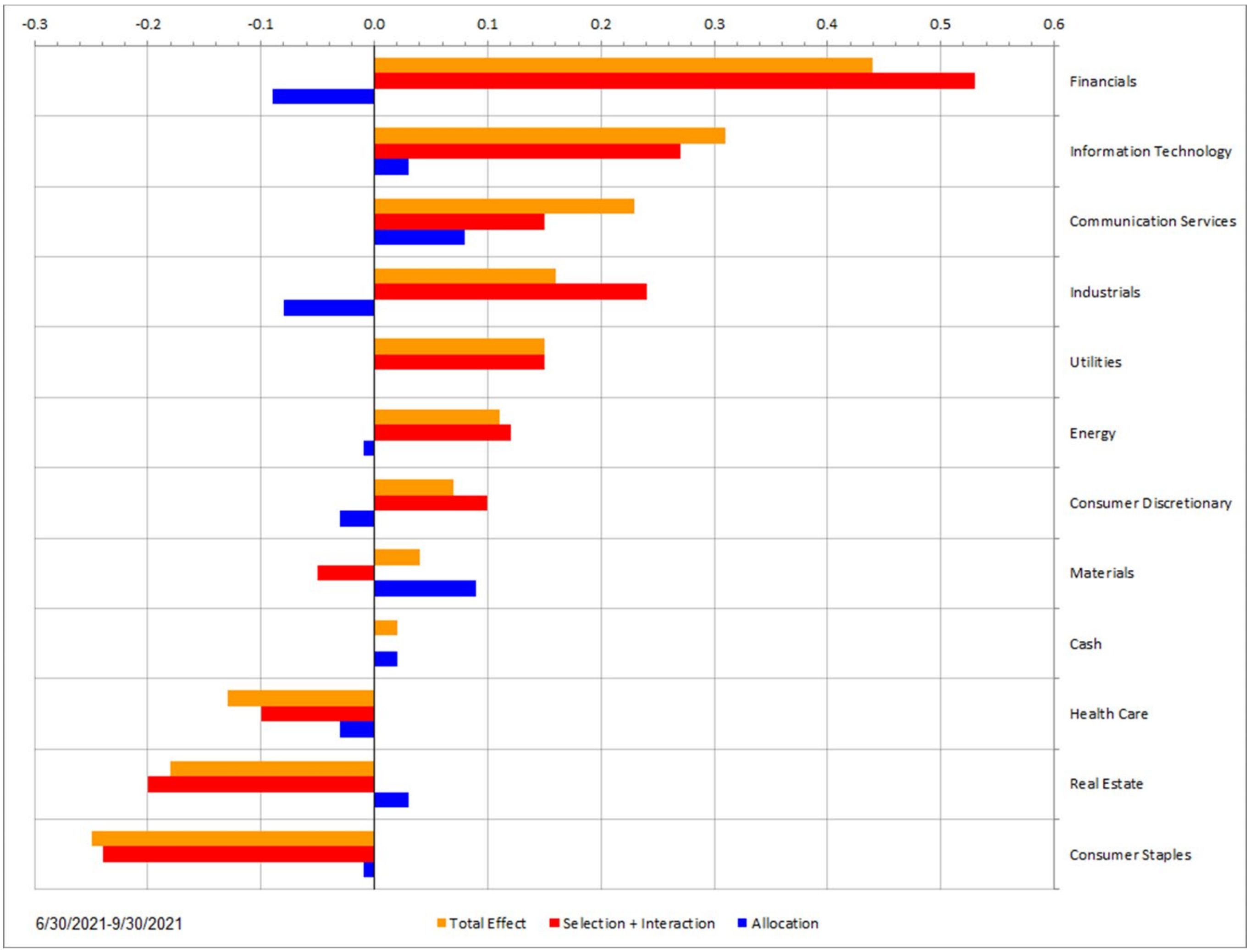
- **Low Price/Earnings Valuation Discipline**: The strategy's P/E is 16.6x 2021 earnings versus 21.9x for the Russell 1000 Value and 25.2x for the S&P 500 (Q3). The 10-year average valuation spread between the strategy and the Russell 1000 Value and the S&P 500 is 2.0x and 3.4x respectively; the current valuation spread is 5.3x and 8.6x respectively.

- **High Absolute Dividend Yield**: The strategy's dividend yield is 3.2% versus 2.0% for the Russell 1000 Value and 1.9% for the S&P 500 (Q3).

- **Strong Dividend Growth**: In the third quarter of 2021, 12 out of 43 portfolio companies raised their dividend payments with an average increase of +14.8%, the highest quarterly rate in several years. Year-to-date, 34 out of 43 portfolio companies (79%) raised their dividends with an average increase of +10.1%.

## Portfolio Attribution:

**Attribution Effects – High Dividend Value vs. Russell 1000 Value 06/30/2021 – 09/30/2021**




Source: SCCM/Bloomberg, 9/30/2021.

The following attribution analysis of the High Dividend Strategy utilizes the Russell 1000 Value Index as the benchmark of comparison for the third quarter of 2021.

Our strong stock selection made ***Financials*** the largest contributor to relative performance for the quarter. Chubb (+9.6%) reported strong 2nd quarter results with operating earnings 20% above consensus estimates, driven by strong growth in net written premiums and net investment income. The property and casualty insurance pricing environment remains very strong, with rates up double-digit percentages year-over-year. Morgan Stanley (+6.9%), Truist Financial (+6.5%), JP Morgan (+5.9%), and Bank of America (+3.5%) all outperformed as several banks posted strong quarterly earnings and a late quarter jump in interest rates and rotation into Value stocks benefitted the group. Our underweight allocation and stock selection within ***Information Technology*** benefitted performance. The sector underperformed as the increase in interest rates led to a sell-off in long duration Growth stocks. Microsoft (+4.3%) posted strong earnings driven by 51% year-over-year revenue growth for its cloud computing platform, Azure. Microsoft also reported robust demand for its Windows operating system, and launched Windows 11, the first new version of that franchise in nearly six years. Cisco (+3.4%) held an Investor Day in September, at which it reiterated its strategy of growing software subscriptions and recurring revenue, particularly in areas of hybrid work technology and cybersecurity. Our strong stock selection within ***Communication Services*** contributed to relative performance. BCE (+2.9%) reported strong revenue per user growth as well as a robust recovery in service revenue. The telecom company's fiber-to-the-home investments are driving residential internet subscriptions and growth. Stock selection also benefitted performance in ***Industrials.*** General Dynamics (+4.8%) is experiencing a robust recovery in its Gulfstream segment as business jet activity has steadily recovered from the Covid-induced lows; furthermore, despite concerns surrounding Defense budgets, the company is seeing strong demand for its Abrams tankers and Virginia and Columbia classes of submarines. Siemens (+3.1%) is seeing a broad demand recovery through all its segments, prompting management to raise full-year earnings guidance. Its digital industries division saw 14% organic revenue growth, smart infrastructure 14% growth, and Siemens Healthineers 25% growth.

Our overweight allocation and stock selection within ***Consumer Staples*** detracted from relative performance. The sector lagged as many packaged food and spirits companies underperformed. Walgreens (-9.7%) shares pulled back in the quarter following a strong recovery in the first half of the year; management guided to higher expenses for the remainder of the year, but the company has administered over 30 million Covid vaccines and is recording higher prescription volumes year-over-year along with rising same-store retail sales. Unilever (-6.5%) shares declined partly on concerns of commodity input cost inflation; yet the company reported strong underlying sales growth, particularly in faster-growing emerging markets. Stock selection within ***Real Estate*** detracted from relative performance. VICI Properties (-7.3%) declined partly on an equity offering that increased its outstanding share count; however, the offering was completed as part of its transformative deal to buy MGM Growth Properties, its largest publicly traded gaming REIT competitor, a transaction that should be accretive to earnings when it closes in 2022. The combination with MGP gives VICI greater scale and could lead to inclusion in major indices. The proceeds of the equity offering were used to prepay secured debt on its balance sheet, which could prompt an upgraded credit rating. Finally, our underweight allocation and stock selection in ***Healthcare*** detracted from performance. The sector outperformed partly on a continued recovery in elective surgical procedures, benefitting medical device companies and pharmaceutical sales. Novartis (-10.4%) declined after management issued full-year earnings guidance below consensus expectations; however, we believe management has taken a more cautious tone, noting that this forecast depends on health-care systems around the world reopening and returning to normal. For Novartis, launching new drugs and increasing share of prescription volumes for the company's sophisticated formulations requires patients to return to doctors' offices.

## Portfolio Changes:

### *Purchases / Additions*

The positions in Altria (MO), Medtronic (MDT), United Parcel Service (UPS), and VICI Properties (VICI) were added to in the quarter.

***Sales / Reductions***

The positions in Johnson Controls International (JCI), Morgan Stanley (MS), Target (TGT) and Welltower (WELL) were reduced in the quarter.

## Dividend Summary:

In the third quarter of 2021, 12 out of 43 portfolio companies raised their dividend payments with an average increase of +14.8%:

- Morgan Stanley (MS) raised its dividend payment by +100.0%
- Bank of America (BAC) raised its dividend payment by +16.7%
- JP Morgan Chase (JPM) raised its dividend payment by +11.0%
- Microsoft (MSFT) raised its dividend payment by +10.7%
- Vici Properties (VICI) raised its dividend payment by +9.1%
- ConocoPhillips (COP) raised its dividend payment by +7.0%
- Truist Financial (TFC) raised its dividend payment by +6.7%
- Altria Group (MO) raised its dividend payment by +4.7%
- Philip Morris International (PM) raised its dividend payment by +4.2%
- Diageo (DEO) raised its dividend payment by +3.8%
- Walgreens Boots Alliance (WBA) raised its dividend payment by +2.1%
- Duke Energy (DUK) raised its dividend payment by +2.1%

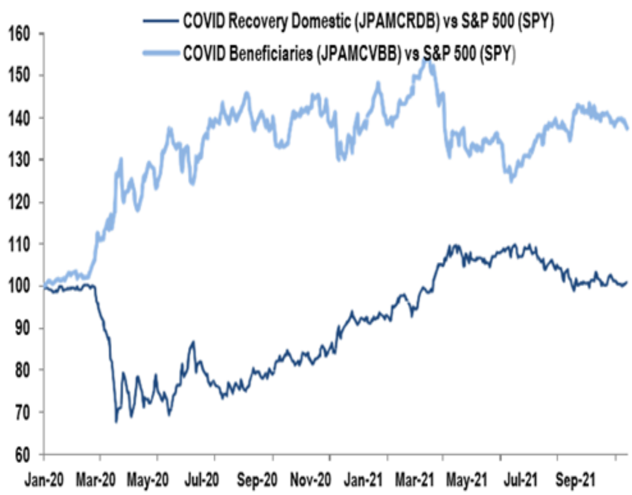
Year-to-date, 34 of out 43 companies (79%) have raised their dividend payments with an average increase of +10.1%.

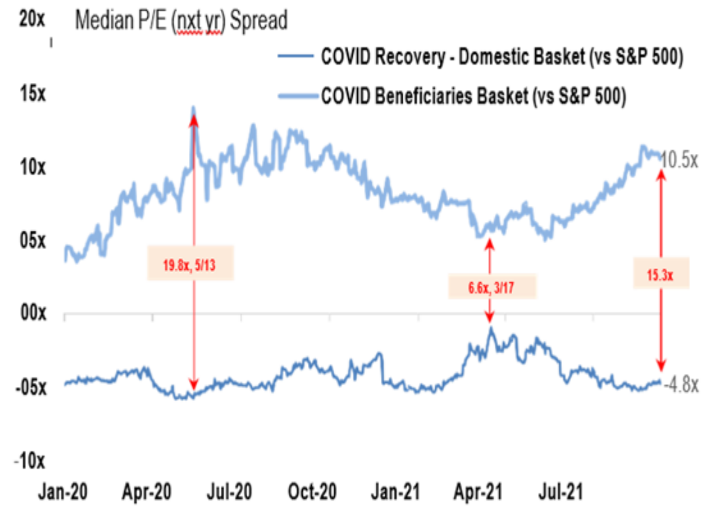
## Market Outlook:

After a historic rally from the March 2020 lows, equity indices paused and consolidated gains as the market digested the impact of decelerating US growth, the surge of the Delta Covid-19 variant, new financial and regulatory concerns in China and Washington DC funding uncertainty along with heightened inflation and supply chain disruptions. Despite these issues, robust financial market liquidity and easy monetary policy conditions continued to provide downside support to markets.

Broadly, Technology benefitted from the heightened concerns and lower rates while several cyclical sectors, Materials and Industrials, with greater ties to the economy took the brunt of market fears. While the correction from recent high price levels has been modest, market internals deteriorated as weakness has spread to a growing number of stocks - the average stock in the S&P has declined 12% from its 52-week high. The divergence in performance between Covid beneficiaries (Growth) and Recovery beneficiaries (Value) has widened considerably to near Q1 levels (Figure 6). As a result, the valuation spread between COVID beneficiaries and Recovery beneficiaries is back near record wide levels (Figure 7).

| Figure 6: Covid Beneficiaries vs Recovery Basket Performance | Figure 7: Valuation Spreads Between COVID Beneficiaries and Recovery Basket |
|---|---|




Source: JPMorgan, US Equity Strategy, 9/15/2021.

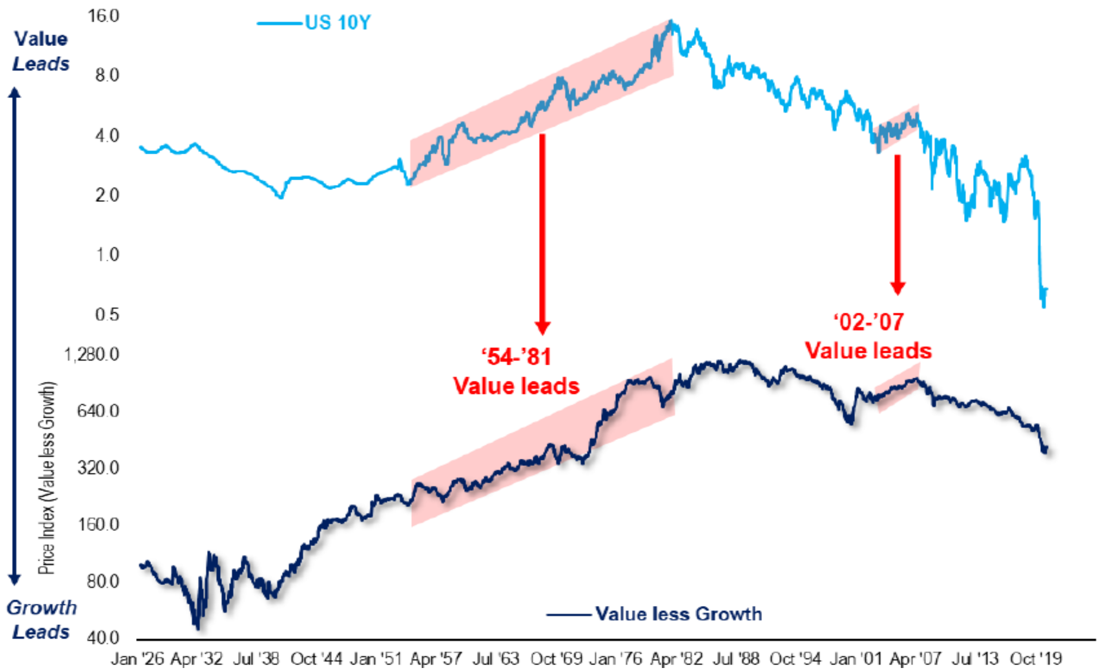
As these recent macro concerns abate, Value stocks should see a lift from an underweight positioning and attractive valuations, especially as these wide valuation disparities narrow. Economic headwinds are now turning to tailwinds, potentially ushering in sustained global growth. The rise of the Delta variant, hampering full reopening, appears to have peaked and as the pandemic lingers on, world populations will increasingly be immunized via vaccinations or antibodies eventually bringing more permanency to the recovery. The deceleration in US economic data, in part caused by rising Covid cases, has set the proverbial "bar" lower for positive surprises. The Citigroup Economic Surprise Index is currently reading levels near the bottom 10% of historical levels potentially propelling equities higher on stabilizing headlines going forward (Figure 8). Lastly, while supply chain disruptions may linger, negatively impacting pockets of companies, over time operations should normalize thus serving to prolong the economic cycle.

**Figure 8: Economic Surprise Index**


Source: Strategas, 9/30/2021.

The direction of interest rates, which had steadily declined due to economic concerns, institutional flows into Treasuries and record short positioning reversing, continues to drive equity style factor performance. Not to be ignored, algorithmic trading, which accounts for over 60% of US equity trading volume, now drives an estimated 50% of US Treasuries trading volume. Falling interest rates, driving flows into long-duration Growth assets, began to reverse at the end of Q3. Improving economic data, declining Covid cases and higher energy prices are but a few catalysts that could drive rates higher, bringing the herd-like momentum traders to reverse bullish Treasury positions. Importantly, value stocks have historically outperformed Growth stocks when long-term rates rise (Figure 9).

**Figure 9: US 10-Year Yields and Value vs. Growth Relative Returns**




Source: Fundstrat/Bloomberg, 9/29/2021.

Dividends have largely been ignored in this cycle as the preference for Growth during the pandemic gave way to a rotation into cyclical re-opening beneficiaries. Quantitative easing over the last 12 years has disproportionally benefitted growth stocks as excess liquidity pushed valuation multiples higher. Since 2009, those periods without quantitative easing have delivered more mixed market returns, including a significantly greater number of periods with market declines. As monetary policy normalizes (taper) and liquidity tightens, volatility is likely to rise and bring with it a greater dispersion of S&P 500 returns. This transition could favor high-quality dividend paying stocks, which have historically performed well in mid and late stages of a bull market. Alongside these considerations, the valuations of high dividend payers are extremely appealing in an otherwise expensive market. Given the incredibly strong equity returns generated this past decade combined with near record absolute valuation levels, forward market returns are expected to be muted, and dividends will likely be a more important contributor to total returns.

Thank you for your continued support. Feel free to reach out to us if you have any questions.

Best Regards,

Schafer Cullen Capital Management, Inc.

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